

MARKET MUSINGS & DATA DECIPHERING

Special Report — Is the Canadian Housing Market in a Bubble?

It sure looks that way.

At a time when personal income is down around 1% over the past year, we have seen nationwide average home prices soar over 20% and last month hit a record high; as did home sales. In real terms, home price appreciation is back to where it was in 1989. Of course, back then, interest rates were far higher but then again, the economy was in the late stages of a phenomenal multi-year economic expansion, not making a transition from deep recession to nascent recovery.

We are in no position to make a claim that there is a high degree of speculation in residential real estate as there was during the “flipping” mania of the late 1980s. Be that as it may, housing has become a very crowded asset class in Canada, as measured by the homeownership rate, which at last count was estimated at 68.4% which is not only a full percentage point higher than the current U.S. ratio but is the highest it has been on this side of the border in nearly four decades.

While the Canadian economy is recovering, overall growth is still barely above zero as manufacturers grappled with excess inventories, a strong currency and a soft domestic demand picture south of the border. Employment conditions have improved, but are hardly that healthy, as we saw in the latest jobs report for November, where wages and the workweek were both down despite a constructive headline number (half of which were in the education sector, an inherently difficult area for statisticians to adequately seasonally adjust).

The bottom line is that even though home prices did come off a soft base from a year ago, so did most other economic indicators and they are still down from the depressed levels prevailing this time in 2008:

- Real GDP -3.2%
- Employment -1.5%
- Retail sales -3.3%
- Shipments -18.6%
- Orders -18.4%
- Exports -18.2%
- Personal income -0.8%
- But home prices are up 22%.

Go figure.

In Canada, nationwide average home prices are now more than 20% year-over-year... and in real terms, it is back to where it was in 1989

While the Canadian economy is recovering, overall growth is still barely above zero and employment is still not inherently healthy

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In answer to the question as to whether prices are in a bubble, all we will say is that when we ran some charts showing Canadian home prices normalized by personal income or by residential rent, what we found is that housing values are anywhere between 15% and 35% above levels we would label as being consistent with the fundamentals. If being 15% to 35% overvalued isn't a bubble, then it's the next closest thing. We are talking about 2-3 standard deviation events here in terms of the parabolic move in Canadian home prices from their lows. So, if it walks like a duck ...

Looking at home prices normalized by personal income or by residential rent, it sure looks like home prices are overvalued

CHART 1: CANADIAN HOME PRICE TO INCOME RATIO*

Canada: Home Price-to-Income Ratio*
(standardized)



*Ratio of resale home prices-to-labour income
Source: Statistics Canada, Canadian Real Estate Association, Gluskin Sheff

CHART 2: CANADIAN HOME PRICE TO RENT RATIO*

Canada: Home Price-to-Rent Ratio*
(standardized)



*Ratio of resale home prices-to-rent as defined by the CPI index
Source: Statistics Canada, Canadian Real Estate Association, Gluskin Sheff



What is driving prices to new record highs (at a time when home values are still down 30% from the peaks in the USA) here in Canada is a very tight supply backdrop (sales-to-new listings and inventory-sales ratios are about the tightest they have been in the past two decades) and surging demand. Even though housing starts have hit 11-month highs, at 70,000 units (annualized) in the single-family sector, we are 40% below the overbuilt levels that touched off the home price slide back in early 1990s (when the unsold inventory broke well above 10 months' supply, for example, in the Toronto area).

So, there has not been a very aggressive response overall by the homebuilding community to the spurt in demand, though construction permits will be a key variable to watch (we do notice all the condominium cranes in Toronto that much is for sure) – and they have risen 16% from year-ago levels and up by 75% from the early-2009 depressed lows. Keep an eye on the evil “I”, which is inventory. That shift towards an excess supply backdrop is what inevitably touched off the price decline back in 2006, and as we saw south of the border, the more overvalued the market is, the harder the decline is likely to be.

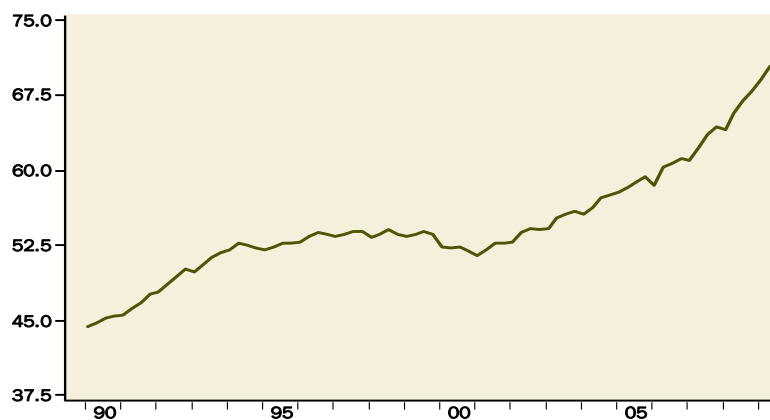
You can't have a home price bubble without a dramatic credit expansion at the same time. Over the past year, residential mortgage balances have risen 7%, which does not sound like a lot, but in the context of deflating personal incomes, it is huge. In fact, mortgage debt relative to Canadian household incomes just moved above 70% for the very first time ever from just over 65% a year ago. But what is fascinating is that mortgages on the books of the chartered banks have actually declined over the last 12 months; all of the mortgage issuance has been securitized as NHA-insured product has ballooned by nearly 40%. Over the past two years, 90% of the mortgages in Canada have been insured by the government (over 100% in the past year).

What's driving home prices to new record highs in Canada?

Answer, very tight supply and surging demand and ...

CHART 3: CANADIAN HOME PRICE TO RENT RATIO*

Canada: Household Mortgage relative to Personal Income
(percent)



Source: Haver Analytics, Gluskin Sheff



What happened here was the Canadian government's move to try and save the housing market from a collapse via the Insured Mortgage Purchase Program – currently, if you have only have a 5% down-payment for a home, you are eligible for an insured mortgage with a 35-year amortization to boot, which, along with record-low mortgage rates, have dramatically improved the financing costs in residential real estate. For current borrowers, carrying costs are very low and you probably don't have to worry about the Bank of Canada raising rates for at least a year. But here is the rub, rates have nowhere to go but up; only the timing is open for debate.

Moreover, based on evidence we have that is purely anecdotal, 40% of the \$60 billion of mortgages issued in 2009 were in very short-term maturities and vulnerable to any shift in central bank policy. Since house prices have risen so far and so fast, and because personal incomes are flat-to-down, housing affordability measures for new housing entrants are actually tied for being the most onerous ever. This may end up curbing demand and if the surge in building permits morphs into an actual dramatic supply response in the coming year, a price retracement of significance in the housing market is an event that we would not exactly label as being 'non trivial'.

As we said, these mortgages are insured by Canada Mortgage and Housing Corporation (CMHC) and in Canada, lenders and servicers are allowed to 'go after' homeowners who default on their debt (ie. in terms of repossessing assets). This is not the land of non-recourse like in the United States.

Now, the banks in Canada have managed to get these high loan-to-value ratio loans off their books for the most part but someone is going to be left holding the bag if the housing mania here pops at some point; and it is probably going to be the Canadian taxpayer. So while a house price reversal would not likely turn into the 'financial event' it did in the U.S.A., it certainly would be an 'fiscal event' and also an 'economic event', and when we are asked what keeps us up at night it is exactly this topic because Canada right now is in the spotlight as being pristine and stable, at least relative to its global peers, when it comes to government deficits and debt ratios. The need for a taxpayer bailout if the home price bubble bursts is not something we are forecasting, but it is something that is near the top of our concern list.

As we said, when there is a bubble or mania in a credit sensitive sector such as housing, excessive leverage is generally a key characteristic. We are not the only one to be concerned over the risks surrounding the seemingly benign, but far from stable, residential real estate market as it pertains to the potential for a rising default rate in the intermediate term if there is any impediment to either the willingness or ability of the Canadian household sector to service its unprecedented mountain of debt obligations. Below, we quote from the Bank of Canada just-released Financial System Review (December 2009) –forewarned is forearmed:

... the Canadian government “saved” the housing market here in Canada from a collapse via the Insured Mortgage Purchase Program

Canadian banks have managed to get these high loan-to-value ratio loans off their books, but will be left holding the bag if the housing mania pops?

In the end, the Canadian taxpayer could be on the hook if the house price bubble bursts here in Canada

“Financial institutions need to carefully consider the aggregate risk to their entire portfolio of household exposures when evaluating even an insured mortgage, since a household defaulting on an insured mortgage would likely be unable to meet its other debt obligations. This implies that the overall quality of a bank’s loan portfolio would deteriorate, even if no loss is incurred on the insured mortgage itself. In addition, claims to recover losses on insured mortgages are not themselves without cost.

The potential for system-wide stress arising from substantial credit losses on Canadian household loan portfolios remains a relatively low-probability risk at the moment, particularly given the near-term prospects for growth. However, the likelihood of this risk materializing in the medium term is judged to have risen as a result of increased indebtedness.

While this suggests that positive momentum in the global economy is stronger than envisioned at the time of the last FSR, economic growth is nonetheless likely to remain subdued for some time as necessary structural adjustments take place.

Deleveraging of the balance sheets of both financial institutions and households, for example, remains incomplete.

Although the uncertainty surrounding the global economic outlook has diminished somewhat, it nevertheless remains elevated. As well, there is a risk that self-sustaining growth in private demand, a prerequisite for a solid recovery, may take longer than expected to materialize, given that the recovery currently relies on an unprecedented level of policy stimulus. Reflecting the high level of uncertainty worldwide, there is a wide divergence in forecasts for global economic growth.

With the slow pace of the recovery, the global economy is vulnerable to additional negative shocks. While the probability of a renewed, synchronous decline in world output is fairly low, even a slower-than-expected recovery may have important implications for the international financial system. If the global recovery does not live up to market expectations, a market correction could ensue. A modest market correction can normally be considered a useful purging of excess risk taking and a re-evaluation of fundamental factors. In the current environment, however, an economic downturn or a significant market correction arising from renewed pessimism could, in a worst-case scenario, reactivate the adverse feedback loop between the real economy and financial markets (by which declines in overall economic growth and in markets reinforce each other).”

We are not the only ones to be concerned over the risks surrounding the seemingly benign, but far from stable residential real estate market

Gluskin Sheff at a Glance

Gluskin Sheff + Associates Inc. is one of Canada's pre-eminent wealth management firms. Founded in 1984 and focused primarily on high net worth private clients, we are dedicated to the prudent stewardship of our clients' wealth through the delivery of strong, risk-adjusted investment returns together with the highest level of personalized client service.

OVERVIEW

As of September 30, 2009, the Firm managed assets of \$5.0 billion.

Gluskin Sheff became a publicly traded corporation on the Toronto Stock Exchange (symbol: GS) in May 2006 and remains 65% owned by its senior management and employees. We have public company accountability and governance with a private company commitment to innovation and service.

Our investment interests are directly aligned with those of our clients, as Gluskin Sheff's management and employees are collectively the largest client of the Firm's investment portfolios.

We offer a diverse platform of investment strategies (Canadian and U.S. equities, Alternative and Fixed Income) and investment styles (Value, Growth and Income).¹

The minimum investment required to establish a client relationship with the Firm is \$3 million for Canadian investors and \$5 million for U.S. & International investors.

PERFORMANCE

\$1 million invested in our Canadian Value Portfolio in 1991 (its inception date) would have grown to \$15.5 million² on September 30, 2009 versus \$9.7 million for the S&P/TSX Total Return Index over the same period.

\$1 million USD invested in our U.S. Equity Portfolio in 1986 (its inception date) would have grown to \$11.2 million USD² on September 30, 2009 versus \$8.7 million USD for the S&P 500 Total Return Index over the same period.

Notes:

Unless otherwise noted, all values are in Canadian dollars.

1. Not all investment strategies are available to non-Canadian investors. Please contact Gluskin Sheff for information specific to your situation.
2. Returns are based on the composite of segregated Value and U.S. Equity portfolios, as applicable, and are presented net of fees and expenses.

INVESTMENT STRATEGY & TEAM

We have strong and stable portfolio management, research and client service teams. Aside from recent additions, our Portfolio Managers have been with the Firm for a minimum of ten years and we have attracted "best in class" talent at all levels. Our performance results are those of the team in place.

We have a strong history of insightful bottom-up security selection based on fundamental analysis. For long equities, we look for companies with a history of long-term growth and stability, a proven track record, shareholder-minded management and a share price below our estimate of intrinsic value. We look for the opposite in equities that we sell short. For corporate bonds, we look for issuers with a margin of safety for the payment of interest and principal, and yields which are attractive relative to the assessed credit risks involved.

We assemble concentrated portfolios — our top ten holdings typically represent between 25% to 45% of a portfolio. In this way, clients benefit from the ideas in which we have the highest conviction.

Our success has often been linked to our long history of investing in under-followed and under-appreciated small and mid cap companies both in Canada and the U.S.

PORTFOLIO CONSTRUCTION

In terms of asset mix and portfolio construction, we offer a unique marriage between our bottom-up security-specific fundamental analysis and our top-down macroeconomic view, with the noted addition of David Rosenberg as Chief Economist & Strategist.

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